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Backgrounder

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Picking Up the Beat:
Why the Bank of Canada Should Move to a Fixed Schedule for Monetary Policy Announcements

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A recently released memo to the minister of finance from his deputy minister, Kevin Lynch, revealed that the Bank of Canada is considering moving to a fixed schedule for making, and presumably announcing, its policy decisions.[1] The memo expresses skepticism about the advantages of the Bank's adopting a fixed schedule, noting that a schedule that was out of sync with that of the US Federal Reserve might expose the Canadian dollar to fluctuations that would force the Bank to act at other times, undermining its own intentions. However, not only does the Fed use a fixed schedule, but in recent years the European Central Bank, the Bank of England, the Reserve Bank of Australia, and the Reserve Bank of New Zealand have all adopted them and appear to have found them satisfactory.

In March of this year, the C.D. Howe Institute waded into this topic with a *Backgrounder* by Bill Robson, the Institute's Director of Research, who suggested that "A Little Rhythm Could Help the Bank of Canada Stay Cool." That is my view, too, for reasons the Lynch memo leaves largely undiscussed. The important part of this proposal is not that decisions be *made*, but that they be *announced*, at regular intervals. A preset schedule for announcing Bank Rate decisions would focus more attention on Canadian economic circumstances and less on other factors, such as the foreign-exchange value of the Canadian dollar. It would thus contribute to the clarity with which the Bank conveys its

1 See "Memo to the Minister: Can the Bank Set Up Its Own Calendar?" *Financial Post*, August 30, 2000, p. C15.

policy messages to financial markets and to the economy at large. This, in turn, would lead to a clearer perception of the extent to which Canadian monetary policy is independent of that of the United States, and perhaps to an improvement in its workings as well.

Policy Independence and Clarity of Communication

The Bank of Canada's policy independence is evident to those who take a long view of the matter. Canada has had lower inflation than the United States for almost a decade, lower interest rates for about five years, and an exchange rate that has varied markedly since floating began in 1970. In the past couple of years, however, whenever the US Federal Reserve has looked ready to tighten, remarks about the inevitability that the Bank of Canada will follow have been commonplace — evidence that many are not convinced of the Bank's long-term independence or perhaps of its relevance to shorter-term considerations.

The extra transparency that moving to regularly scheduled policy announcements would add to the Bank's communications with financial markets and the public is, in itself, sufficient justification for making it. The Bank's current routine of changing interest rates at irregular intervals, when circumstances seem to require it, and accompanying such changes with an explanatory announcement, sometimes creates problems. It is an important but often overlooked fact of monetary policy that a decision *not* to change interest rates is sometimes just as important as one to do so, and needs just as much public explanation.

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The Bank occasionally has not moved when observers expected it to, leading, in the absence of an immediate explanation, to doubts about its intentions. Was the Bank asleep at the switch? Did its officials know something that markets did not? Or was a move actually imminent? Such speculation has introduced an unnecessary element of uncertainty into financial markets. But it is inherent in the Bank's current way of doing things. A fixed schedule for announcements would eliminate that uncertainty.

Furthermore, properly chosen intervals between announcements would add an extra beat to the Bank's already established rhythm of policy statements. The governor's *Annual Report*, the semi-annual *Monetary Policy Report*, and the updates that come a quarter after its release could be supplemented by briefer announcements at regular intervals between the updates. Information about the Bank's longer-term intentions could still be conveyed in public speeches by the governor and other senior Bank officials. And the Bank could still move, and explain why, at other times should special circumstances arise (though such events should be rare). I think it can be taken for granted that Governor Thiessen and his colleagues have enough sense to avoid the pitfall of scheduling their announcements to coincide with or follow hard behind those of the Fed.

Regular monetary policy announcements are not new. Before 1996, the Bank Rate, charged by the Bank of Canada on the banking system's overdrafts of settlement balances, was set weekly. Its value was fixed at 25 basis points

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above the rate established on three-month treasury bills at their weekly auction. It turned out, however, that this system attracted more attention to the weekly auction than the event merited, and because the Bank itself exerted less than precise control over the auction's outcome, the market often got confusing signals about the Bank's intentions. That is why, in early 1996, the system was changed.

Since then, the Bank has announced the range within which it intends to hold the interest rate on overnight loans among and to commercial banks — with the top limit to that range playing the same role the Bank Rate did under the old system — only when it deems a change necessary for policy purposes. In early 1999, it further clarified its procedures by fixing 9:00 a.m. as the time at which it would announce any change to this range.

Such arrangements, which supplement clearly defined medium-term inflation targets and operate against the background of a flexible exchange rate, have worked quite well most of the time. However, they have sometimes given rise to communication problems, with real consequences.

Interest Rates and the Exchange Rate

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In setting the overnight rate, the Bank of Canada, in its dedicated goal of keeping the inflation rate within a certain range, should ignore the exchange rate *except to the extent that its behavior is an independent source of disturbance to the inflation rate*. The Bank has always taken this italicized qualification seriously. Although it is sincerely committed to inflation targets and to a flexible exchange rate that accommodates the pursuit of those targets to whatever is happening in the rest of the world, the Bank has never been willing to declare its indifference to the behavior of the exchange rate, no matter what the circumstances. Presumably it fears that such a declaration would increase the likelihood of markets testing the Bank by driving down the exchange rate in a potentially inflationary manner.

To complicate matters further, the Canadian and US economies are closely interlinked. Many of the shocks that affect the United States also affect Canada and require a parallel policy response in the two countries. For example, to the extent that variations in business and household confidence about the future course of real activity in the two economies are correlated and require a tightening of monetary policy to forestall their inflationary effects, that tightening must take place in both countries. In such circumstances, the Bank of Canada's failure to act in harmony with the Fed — and as a byproduct to support the exchange rate — would be inconsistent with its domestic goals. But not all shocks are like that. An upturn in the outlook for domestic inflation in the United States resulting from prior laxity on the Fed's part would require the Fed to take offsetting action, but it would be a mistake for the Bank of Canada to follow in such a case.[2]

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2 The Bank's failure to act in such circumstances might have an impact on the Canadian dollar, but it would be short term and limited in scope. Over the medium and longer term, the effects of a relative tightening of US policy on the Canadian/US dollar exchange rate essentially would be offset by the effects of threatened higher US inflation.

In principle, it is easy to distinguish between such differing circumstances and to decide when the Bank should move with the Fed and when it should not; in practice, this can be difficult. All we ever see is the Fed changing US rates. The Bank then has to decide whether Canadian circumstances warrant following, while markets have to forecast the Bank's response and judge the appropriateness of the response on the basis of incomplete information about the underlying economic circumstances.

An Incipient Vicious Circle

Any factors that bias the outcome of such decisions must give concern. Too many incentives in the Bank's current procedures make simply following the Fed its path of least resistance, and the markets have come to expect this.

Private sector expectations about future inflation are, in themselves, indicators — albeit imperfect ones — of future inflation. They therefore influence long-term interest rates, providing useful input to policy decisions. However, private sector expectations about the Bank's future policies also influence long-term interest rates. Whenever the Fed is expected to move (for domestic reasons but incidentally putting pressure on the exchange rate), private sector expectations that the Bank of Canada will routinely follow the Fed's lead affect long-term interest rates, in turn increasing the Bank's incentive to tighten policy as expected. If the Bank decides not to respond and chooses not to say why, it risks weakening market confidence in its intentions, thus making more likely the very kind of portfolio shifts that it fears could create exchange rate movements, with consequences for domestic inflation.

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Under current procedures, the more the Bank simply follows the Fed's interest rate changes, whether they are for good or mistaken reasons, the more difficult it becomes for the Bank to ignore the Fed next time around, even when domestic circumstances demand it. In other words, the Bank risks getting trapped in a vicious circle that undermines its policy independence.[3] Small wonder, then, that some observers conclude that Canada's monetary independence is a sham, that where the Fed goes the Bank of Canada must follow, and that the sooner Canada stops pretending otherwise and adopts a pegged exchange rate — perhaps as a prelude to negotiating a common currency arrangement with the United States — the better.

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3 The Bank hardly helped itself in the mid-1990s by giving prominence to its monetary conditions index (MCI), a weighted average of the exchange rate and a short interest rate, when discussing the stance of policy. That prominence gave rise to a widespread belief that the Bank's policy, over short periods at least, was to stabilize the MCI at its already prevailing value. Any tendency for the exchange rate to depreciate was, therefore, expected to prompt an increase in interest rates, while exchange rate appreciations were expected to prompt decreases. Though the Bank has long since de-emphasized the MCI in its pronouncements, this impression has lingered, hampering policy.

Breaking Out of the Circle

There is not much the Bank can do about this by way of policy actions. It would be absurd, not to say damaging, for the Bank to change interest rates independently of the Fed, for example, merely to demonstrate that it can. The problem here is essentially one of communication. However, the Bank has been unwilling to attempt to solve it by simply declaring once and for all that it ignores the exchange rate when implementing policy. And to be fair, such a once-and-for-all announcement, if not followed up with a readily observable change in behavior, would lack credibility.

Adopting a fixed schedule (except in cases of emergency) for announcing and explaining monetary policy decisions would provide a number of advantages. First, as I remarked at the outset, a decision *not* to change interest rates can be just as important as one to vary them; either way, the public deserves an explanation. With a fixed schedule for policy announcements, it would always get one.

Second, of particular relevance to recent experience, the question of whether a policy change by the Bank will follow immediately one taken by the Fed would become less dominant in short-term speculations about Canadian monetary policy. Market participants would always know the date, and indeed the time of day, when their questions about Bank actions were to be answered. They would be able to observe Fed action or inaction as one relevant factor, pay due attention to others that are relevant to the likely future course of inflation, form their expectations about, and take their positions in anticipation of, the Bank of Canada's decision.

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The markets would quickly learn to focus more on variables pertinent to the domestic inflation outlook and less on the exchange rate and US policy — particularly if the Bank were to take the opportunity to focus on its long-term domestic goals, both in its policy actions (or inactions) and its explanations of them. The possibility that a vicious circle would lead the Bank to overemphasize US variables in its decisionmaking because it was expected to do so would correspondingly diminish. And it would diminish further as markets learned more about the new regime.

Finally, it is worth noting explicitly that for the Bank of Canada to move to a regular schedule of policy announcements need imply no alterations in the decisionmaking that underlies them, though the Finance Department memorandum seems to suggest that this is being contemplated. If the timing of announcements is chosen to fit into the Bank's existing pattern of policy communications and on the presumption that this pattern is already synchronized with the Bank's internal work schedule, no such changes would be required.

Conclusions

The concern expressed in Mr. Lynch's memorandum that exchange-rate fluctuations might make a regular schedule of Bank of Canada policy

decisions and announcements unsustainable is unlikely to be borne out. The important element here is not regular *decisions* but regular *announcements*, as the advantages of such a move relate to policy transparency. Since the clarity with which the Bank communicates its decisions can affect the environment in which those decisions are made, however, the change may make monetary policy easier to conduct as well. A fixed schedule for Bank policy announcements makes good sense.

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